Economic & Market Update, August 2016

Unimaginable Risks

By Richard Morey

There is a game called Jenga in which players attempt to remove a block and place it on top of a stack of them without toppling the entire structure. I thought of this after deciding to write an article updating readers on global economic and market risks and attempting to predict which country or event will precipitate the next global recession.

Now I have never played Jenga and have no reason to believe I would be particularly good at it. However, I do know this is the second longest game of "economic Jenga" since the Great Depression. There have been 14 recessions in that time period, and the average length between them has been 4.2 years. It has now been over 7 years since the last recession. In addition, the "economic recovery" since the last recession has been the weakest since World War II. By now a slight breeze can topple this towering, unstable edifice.

In reality, the apparent cause of the next recession will not be the true cause. This is because the ultimate cause of most recessions, and almost all stock market collapses, is too much bad debt, i.e. debt which will never be fully repaid. These loans have already been made and cannot be reversed. Following a financial crisis caused by too much debt, we have now had the single largest explosion of debt the world has ever seen. Total debt in the world has blown up over 40% since 2009! Total corporate debt in China has expanded by a stunning 400% since then, while Japanese government debt has grown to heights rarely if ever seen in the world. As a result of all this debt, the losses in the next recession are already "baked in the cake."

KEY TAKEWAYS

U.S., China, Japan and Eurozone all have massive debt problems.

- Those debts are retarding Economic growth globally.
- GDP (Gross Domestic Product) is weak & may already be recessionary.
- U.S. Stock Market continues being propped up by Central Bank intervention.
- Safe, investment grade bonds are benefitting from sluggish economic conditions.

I am also aware the most likely event which will precipitate the next recession and stock market collapse will probably not even appear in this report. For example, the Asian financial crisis of the late 1990s began with a collapse of Thailand's currency, an event which did not appear on my list of economic risks at that time. Still, looking at the risks we can see will highlight just how dangerous the world economy and stock markets are at this time.

China

We begin with China because their economic imbalances may be the most unstable. Plus, Chinese economic growth had been the engine for world growth for several years beginning in 2009. Unfortunately, much of this growth was caused by the aforementioned explosion of debt. Earlier this year the modest stock market swoon here in the U.S. was at least partially due to fears China's losses may upend the world economy. However, since late spring the prevailing view has been China is now stabilized. What a joke!

The Chinese authorities know they have a huge problem caused by too much bad debt, and they desperately want to reduce it. But each time they attempt to rein it in the economy begins to drop immediately. They therefore switch courses on a dime. Through the first half of the year, China is on course to increase total bank debt by approximately $3 trillion this year, in a $10 trillion economy. This is after total debt in China grew by over well over 400% in the previous 7 years! Earlier in the year they began to increase debt more than at any time in their history. And they are doing it even though their main, constant worry (or terror might be the better adjective) is they have too much debt. But if they instruct their banks to stop making loans to companies needing another loan to pay off their old loans, they will have a tsunami of companies going bankrupt. This will result in millions of newly unemployed workers, and millions of investors who backed these loans, believing they were guaranteed by the government, losing their money. In other words, the government would face widespread, destabilizing social unrest.

One rule to keep in mind is that, when a country allows or encourages an explosion of debt, huge losses are absolutely inevitable. There is no way out except down. So what can China do? The best, and possibly only, way to slow down the coming losses would be to devalue their currency - a lot. Most of their larger corporations at risk of bankruptcy are either in manufacturing or dependent on it. In fact, their entire economy is dependent on manufacturing, but the world economy is slowing down further and China built far too many factories.

The best analysis of world trade is done by the Netherlands Bureau of Economic Policy Analysis. Their latest report shows the description you may have heard in the financial media describing world trade growth as slowing to be incorrect. World trade growth is not slowing; it began shrinking in early 2015. Historically, this has rarely occurred without the world entering recession shortly thereafter.

If China lowered the value of their currency by 30%, this would mean all the goods they make for export would cost 30% less to their foreign customers. They desperately need to take this action before other countries do more to lower the value of their currencies. Japan is one of China's largest competitors for exports, and Japan has already entered a currency war with the rest of the world. Of course, like nearly all their other monetary and fiscal experiments, thus far Japan's efforts have backfired. But unlike Japan, China does not have to depend on markets to devalue their currency, as they set the price themselves.

Should China do a huge devaluation of the yuan, they would prop up their manufacturing sector, and therefore their entire economy, for a while longer. However, this would lead to serious deflation in the rest of the world. U.S. companies who compete with China would have to slash their prices. This would be great for shoppers, but the resulting corporate bankruptcies would plunge us (and Europe and Japan) straight into recession. If I was running China I would do this today, and many of the best economists say China has no choice but to dramatically devalue their currency as soon as possible. We will literally be in recession the day after they do this, with 100% certainty.

Developing Markets

Developing markets basically include all economies except the United States, Japan, and Europe. China and India are the largest developing markets, and countries such as Malaysia, Vietnam, Indonesia and all the countries in South America are other examples. While I have written China has had the largest explosion of debt in history, the other developing markets have actually done exactly the same thing. Corporate debt in emerging markets has risen $13 trillion since 2009 and has increased more than 500% over the past ten years!

A crisis in emerging market debt probably should be the #1 risk on this list, if only because it gives us dozens of countries from which to choose as the place where the next recession will originate. Just like the discussion on China, the match to light this fuse could be currencies. Much of the money was borrowed in U.S. dollars. If the dollar continues to rise relative to the emerging market currencies, investors will be losing more and more money on these loans. At some point they will stampede for the exits, pulling their money out of these countries. In our global economy this could lead to a severe worldwide recession.

Europe

Europe could be first on our list because their largest banks may face a crisis any day. China could put us into recession tomorrow, while Europe's banks could do the job in a week. The most obvious risks are in

Italian banks. Italy’s banks have, approximately, a stunning $350 billion of bad debt, i.e. loans on which the borrower is no longer able to make payments. This is approximately 20% of all their loans. To put this into perspective, at the height of our financial crisis in 2009, “only” 5-6% of bank loans in the United States were in default. Beyond any reasonable doubt, Italy’s banking system is bankrupt.

But it gets much, much worse when we look to the north. This is because two other banks which are also in danger of insolvency are Deutsche Bank, Germany’s largest bank, and Credit Suisse, Switzerland’s largest. This is far more dangerous than Italian banks because these two banks are, according to the International Monetary Fund, two of the three most “systemically important” banks in the world. This means if either one of these banks becomes insolvent, they essentially owe so much to the other largest banks in the world those banks would also then go bankrupt. Should this occur, the resulting financial crisis would dwarf what we experienced in 2008-2009. When I say “dwarf,” take the banking losses from 2008-2009 and multiply them by 10.

Now I do not believe for a second the European Central Bank (ECB)/European Union will allow either of these banks to go under. Neither will they allow the larger Italian banks to declare bankruptcy, as this could create a chain reaction in which Deutsche Bank and/or Credit Suisse would end up collapsing. No, the European Central Bank will again break all its own rules and make sure European taxpayers cover the losses. This will lead to even louder protests against the European Union and could end up leading to other countries deciding to leave this failed monetary union. One more vote to leave the European Union would plunge us directly into, at the very least, a severe recession.

It is worth noting recent ECB actions are wreaking havoc on European banks. According to top Deutsche Bank executives, the negative interest rates the ECB has implemented makes it impossible for banks (and insurance companies and pension plans) to succeed.

Finally, we should keep in mind the entire European Union economy is already on the edge of recession, with growth rates recently falling well below 1%. Today on CNBC a European stock market expert simply stated, “There is no growth in Europe.”

Japan

Japan's economic situation is surely unique in the history of the world. Their economy essentially stopped growing 25 years ago. To try to combat this they went into more debt than the world has ever seen, a phenomenon that continues to grow each day. There is no economic theory to explain what has gone on in Japan. To have such a large economy stagnate for 25 years is rare. To have this occur while their total debt (public and private) balloons to 615% of GDP is pretty much impossible (a total debt level above 275% is considered unsustainable). Their financial system should have been decimated many years ago, toppled by a mountain of debt everyone knows can never be repaid. Given this certainty much of their debt will never be repaid, how in the world can they continue to borrow nearly unlimited amounts of money?

In reality, nobody in the entire world is actually lending their government money. Instead, their central bank prints all the money they don't have to cover their expenses and "loans" it to their government. (They actually still use "middlemen," as private banks first loan the money to the government and then sell the bonds to their central bank.) It was shocking to watch (two years ago) when their central bank, the Bank of Japan, stopped purchasing Japanese Government Bonds one week. During that week, not one of these bonds was purchased by anyone in the entire world! Keep in mind there are over $10 trillion of these bonds, and nobody in the world would touch a yen's worth if their central bank wasn't going to immediately buy it from them.

I won't go into further details here, as this is a very complicated topic. The shorthand version is the yen *should* have collapsed many years ago. Every clear-thinking person who studies Japan’s financial situation knows this. However, it is extremely difficult to figure out why it has not already occurred, and therefore nearly impossible to guess when it will happen. That being said, the Japanese economy is almost always either entering a new recession, already in one, or growing so slowing it won’t be long until the next recession arrives. So while they may not cause the next global downturn, they will assuredly experience the negative effects.

The United States

From one angle we are the least likely to cause the next global recession. Our economy certainly looks better than the others. Like them, we do have extreme debt problems, low growth, and unusually large economic imbalances. Our problems just aren’t as large as the others. From another perspective we may actually be the most likely to kick off the next worldwide recession. This is because the rest of the world is looking at U.S. growth to save them. Being the largest economy in the world, if the U.S. grows it tends to bring everyone else along upward. At the same time, if the largest and “strongest” economy falters, it is almost guaranteed to bring a tidal wave of bad debts around the world to the surface.

This is not good news for the world, as the U.S. economy continues to weaken. History will probably look back at our economy and say we had the slowest movement ever into this next recession. This movement does now appear to be picking up some steam. For the first half of the year, our economy supposedly grew at nine-tenths of one percent. I say ‘supposedly’ because whenever we have the next recession we will find out we entered it approximately three quarters before it was recognized. In other words, if a recession is spotted and announced later this year, they will downgrade the .9% growth in the first half of this year to a negative number.

In previous reports we have detailed all the concerns we have about the U.S. economy, and I won’t repeat them all here. What is new is we are seeing more and more data that has never occurred in history unless we were either already in a recession or would enter one in less than six months. For example, corporate profits have now been going down since the last quarter of 2014, something you would typically only find during a recession. Both imports and exports have been falling for over a year, as have business sales, industrial production, factory orders, etc., etc. Some of this data goes up for a month or two, but the overall trend is down. Corporate bankruptcies continue to spike up and are now higher than they were in *late 2009*. Simply put, we have never seen this much weakness in major areas of the economy without a recession. Overall the economy is back to where it was in 2010, and growth rates continue to fall.

The Stock Market

Unfortunately, the above is *far* from a complete inventory of all the worldwide economic and market risks. Turning directly to the stock market, we see corporate earnings fell *again* in the second quarter and are now down over 20% from the fourth quarter of 2014 and a full 40% from where they had been projected to be today back in 2014. With the combination of increasing global risks, falling economic growth *and* corporate profits, stocks obviously should be going down – yet they have rebounded since Brexit – which was supposed to have ushered in economic catastrophe? This time I am not alone in thinking this is absurd. In the last two weeks I have read reports from many experienced stock traders who say this is the most irrational stock market ever.

The reason stocks have gone up is fairly obvious. Beginning the day after the Brexit vote, the European Central Bank and Bank of Japan ramped up their printing presses to the tune of over $180 billion a month. This is the most quantitative easing since Bernanke started in full force in 2009. Since investors continue to have blind faith in central banks, if central banks are printing money it must be time to buy stocks.

This reminds me of the title of an article recently published about our current situation: *All Fun and Games Until Someone Loses an Eye.* This is something a parent or other responsible adult would say to children. Investors are the children, and unfortunately there are no responsible adults in the room. Instead, the kids are being supervised by central bankers who are handing them live grenades as toys!

Here is the sober adult perspective. A run-of-the-mill recession and bear market for stocks – something that has a 100% probability of occurring – will erase all U.S. stock market gains since the beginning of the year 2000. This is what is in store for stock investors. I hope they do not suffer larger losses, but any of the major world economic risks could make their losses more severe. It doesn't matter if this begins today or in several months, and it doesn't matter if stocks go higher from here. Stock investors will lose – at least – all their profits since 2000.

The Bond Market

The overall direction for the safest U.S. bonds, specifically Treasuries and related bonds, remains positive. It never ceases to amaze how so many alleged investment experts have no idea what moves bond prices. A weakening economy equals rising bond prices. (Note the exact opposite applies to high-yield or junk bonds. Also note a weakening economy is not the only force driving bond prices higher, though the others are all connected to economic weakness.) However, almost the entire financial industry has blindly believed the Fed's yearly pronouncement that the following year would be the one in which we finally reach "escape velocity." They have said (and continue to say) we really do have decent growth today, with some lingering or new problems, but next year we're going to take off. Then they are wrong again. Now we find the economy has grown more slowly over the last year than any year since 2010. Yet each year the financial industry buys into the Fed hype. Accepting their dream the economy will soon take off as reality, market analysts are sure interest rates must be going up, thereby driving down bond prices.

At the beginning of the year I shared the following: "As a nation, our total debts increased by $1.9 trillion last year while the economy only expanded by $549 billion. This fact basically guarantees the economy will slow further in 2016 and beyond." This is indeed what is occurring, and I'm sure we'll see even more new debt relative to growth by year's end.

A weak economy equals low interest rates and higher bond prices. The bond market has been fairly volatile this year. It went straight up early in the year, leveled off, then resumed gains until early July. After dropping for two weeks it rebounded into the end of last month. Continued volatility certainly would not be surprising, but a weakening economy equals rising bond prices, and the economy is weakening. And sooner or later the stock market will indeed gap (far) down, at which time the prices of the safest bonds will spike upwards as investors sell stocks in fear and frantically put their money into the safest investments, which remain U.S. government bonds and related securities.